

## The *Indofoods* and *Prevost* Cases - The Meaning of Beneficial Ownership

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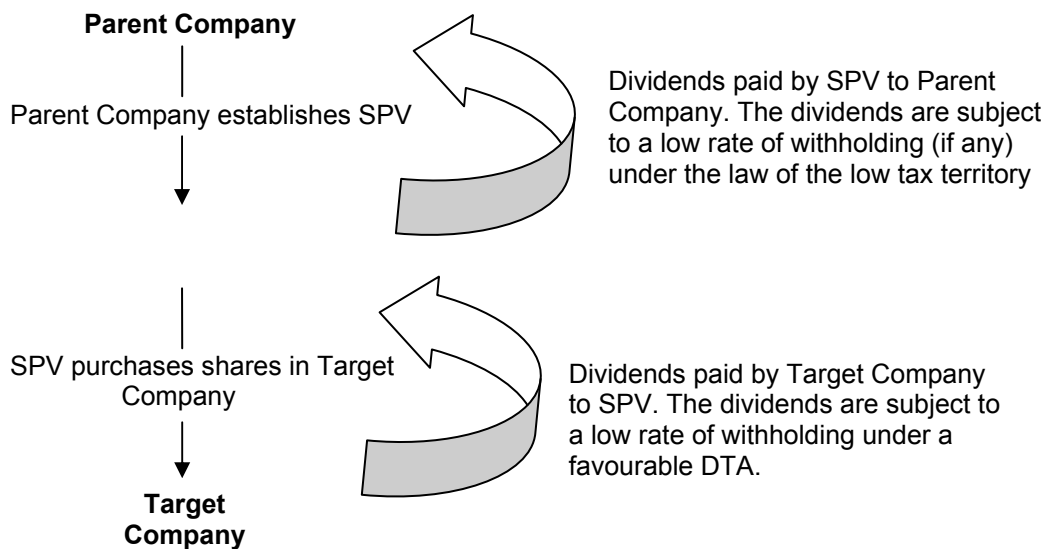
### Introduction

Corporate entities commonly incorporate an offshore special purpose vehicle (**SPV**) to:

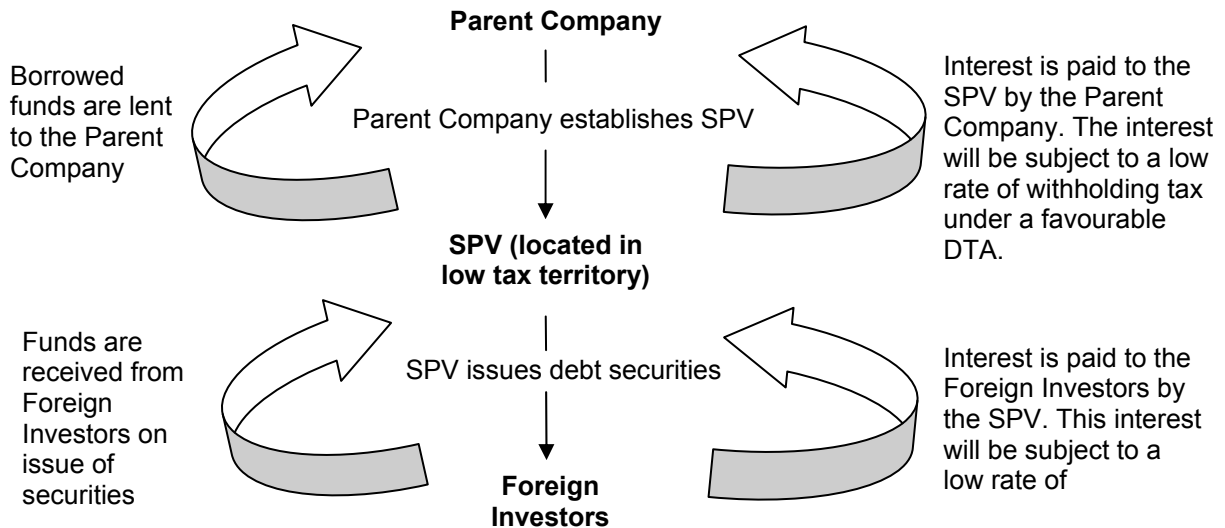
- (a) purchase shares in a foreign target company; or
- (b) issue debt securities.

By strategically locating the SPV in a low tax territory with a favourable double tax agreement (**DTA**), an entity making an equity investment or issuing debt securities may be able to reduce the level of withholding tax on dividends they receive or interest they pay. The diagrams below demonstrate two simple scenarios where an SPV could be used to minimise withholding.

### Foreign Equity Investment through SPV



**Issue of Debt Securities through SPV**



To take advantage of the favourable rates of withholding under the DTA, it is vital for the SPV which receives the dividends or interest to be the “beneficial owner” of that income. The concept of beneficial ownership appears in the dividend and interest articles in many New Zealand DTAs as a precondition to gaining relief.

The term “beneficial owner” is not defined in the OECD Model Tax Convention (**MTC**) and until recently there has been limited international case law discussing the meaning of the term.

However, two recent judicial decisions have considered the concept of beneficial ownership. The two decisions are polemic. The English Court of Appeal decision in *Indofoods International Finance Ltd v JP Morgan Chase Bank NA* [206] EWCA Civ 158 has taken a substance over form approach to the meaning of the term “beneficial owner”, whereas the Tax Court of Canada’s decision in *Prevost Car Inc v R* 2008 TCC 231 took a form focused approach to interpreting this concept.

The form based decision in *Prevost* is currently on appeal, and if the case is ultimately decided along the lines of *Indofoods*, it will have important ramifications for a variety of common corporate structures.

***Indofoods***

In March 2006 the English Court of Appeal reversed a decision of the High Court and held that a SPV in the Netherlands was not the “beneficial owner” of interest received from its parent company where that interest was paid on by the SPV to third party note holders.

PT Indofoods Sukses Makmur (**Indofoods**) was a company incorporated in Indonesia that sought to raise capital by issuing loan notes on the international market. If the issue had taken place in Indonesia, a 20% withholding would have applied to any interest paid to the investors. To circumvent this withholding, Indofoods incorporated a subsidiary in Mauritius (the **Issuer**) which issued the notes and on lent the capital raised to Indofoods. JP Morgan Chase Bank (**JP Morgan**) was appointed as trustee and paying agent for the note holders.

Withholding on the interest paid by Indofoods to the Issuer was limited under the Mauritian/Indonesian DTA to 10%. There was no withholding on interest paid by the Issuer to the note holders as Mauritius did not impose withholding tax on interest paid to foreign investors.

The notes were redeemable in June 2007 but could be redeemed earlier if there was a change in Indonesian law resulting in withholding rates exceeding 10%. However, the Issuer was required to take reasonable measures to circumvent the extra withholding if a change of law arose.

In May 2004 the Indonesian government announced that the Indonesian/Mauritian treaty would conclude in January 2005. This would result in a 20% withholding rate applying to the interest paid from Indofoods to the Issuer. It was in Indofoods’ interest to redeem the notes early as exchange and interest rates had moved against it and Indofoods could access cheaper funds elsewhere. Conversely, it was in the interests of the note holders for the arrangement to continue.

In August 2004 the Issuer informed JP Morgan (as trustee for the note holders) of its intention to redeem the notes and certified that no reasonable measure could be taken to reduce the withholding liability. JP Morgan refused to give approval based on the argument that it would be reasonable for a new company (**NewCo**) established in the Netherlands to be interposed between Indofoods and the Issuer to reduce the rate of withholding to either 10% or 0% depending on the term of the loan.

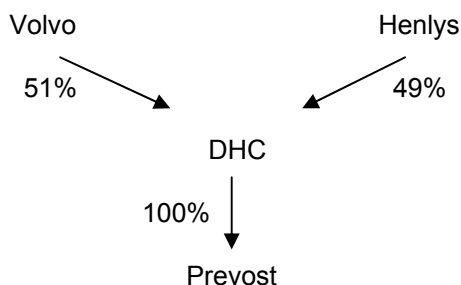
The case went to the English Court of Appeal which examined (among other things) whether NewCo would be the beneficial owner of any interest paid to it by Indofoods.

The Court came to the conclusion that NewCo would not be the beneficial owner of the interest paid to it by Indofoods. As a result the treaty would not operate to reduce the withholding on interest. The Court reached this conclusion by examining the relevant DTAs and the various commentaries on the MTC. The 2003 OECD Commentary explained that the term “beneficial owner” is not used in a narrow technical sense, but rather it should be read in its context and in light of the object and purposes of the convention. The Court explained that its decision was consistent with the purpose of the DTAs, being the avoidance of double taxation and the prevention of tax evasion. The Court stated that it would be wrong to limit the term “beneficial owner” to a technical or legal interpretation. Rather, the focus should be on the substance of the matter.

On the facts in question, NewCo would be bound to pay the interest it received from Indofoods to the Issuer and the Issuer would be bound to pay the interest to the paying agent and trustee of the note holders. As a result, both NewCo and the Issuer were not true beneficial owners as they did not have “full privilege to directly benefit from the income”.

## ***Prevost***

A very different outcome was reached by Associate Chief Justice Rip of the Canadian Tax Court in *Prevost*. *Prevost Car Incorporated (Prevost)* was a Canadian resident company, the shares of which were held by a Dutch holding company (**DHC**). The shares in the DHC were in turn held by Volvo, a company resident in Sweden, as to 51%, and by Henlys, a company resident in the United Kingdom, as to 49%.



Volvo and Henlys entered into a shareholders’ agreement in which they agreed that not less than 80% of the profits of Prevost and the DHC (referred to as the “corporate group”) would be paid by the DHC to

Volvo and Henlys, whether as dividends or otherwise. Any payments of profits were generally to be subject to the corporate group having sufficient financial resources to meet its working capital requirements at the time payments were made to Volvo and Henlys.

At a meeting of the shareholders of Prevost, a dividend policy was agreed whereby following the completion of quarterly accounts, and subject to adequate capital being available to Prevost, 80% of the net retained profit after tax should be paid by the end of the following quarter. ACJ Rip pointedly made reference to the “purported shareholders” of Prevost, noting that the minutes of the shareholders meeting at which the dividend policy was resolved state that the meeting was attended by proxies for Volvo and Henlys. However, the only shareholder in Prevost was DHC.

In practice, Volvo and Henlys would press Prevost to pay dividends to DHC, rather than DHC seeking payment from Prevost as its sole shareholder. Prevost paid dividends to DHC, which in turn resolved to pay dividends to Volvo and Henlys. In one instance, over \$5m was transferred to Henlys on the instructions of its financial director without the directors of DHC signing a resolution.

DHC’s registered office was in the offices of Trent International Management (**TIM**), originally located in Rotterdam and later in Amsterdam. DHC’s directors executed powers of attorney allowing TIM to transact limited business on its behalf, and to sign payment orders in respect of dividend payments to Volvo and Henlys. DHC had no employees in the Netherlands and no other investments except for its shares in Prevost. Disclosures DHC made to its bank for the purposes of anti-money laundering rules suggested that the beneficial owner of the shares in Prevost were Volvo and Henlys, not DHC itself.

The Canadian Minister of Revenue assessed Prevost on the basis that the beneficial owners of the dividends it paid were Volvo and Henlys. Therefore, Prevost should have withheld tax on the gross value of the dividends at the rate of 10% for Henlys and 15% for Volvo. Prevost had been withholding tax at the significantly lower rate of 5%, relying on articles 10(1) and 10(2) of the DTA between Canada and the Netherlands.

The Minister of Revenue sought to rely on the Vienna Convention, case law, the DTAs in issue and the MTC to argue that “beneficial owner” should be given a substantive as opposed to a technical or legal meaning. The minister of Revenue argued that one must look behind the legal relationships and identify who ultimately benefits from the dividends. To bolster this argument, the Minister of Revenue advocated the approach taken by the English Court of Appeal in *Indofoods*, outlined above.

The Tax Court found in favour of Prevost. It was heavily influenced by the expert evidence it procured, which favoured a formalistic interpretation of beneficial ownership. The first expert witness, Professor van Weeghel, gave evidence that DHC would be regarded as the beneficial owner of the dividends under Dutch law unless it was obligated to pass the dividends to Volvo and Henlys. DHC was not party to the shareholders' agreement, and so the court held DHC had no legal obligation to pass dividends to Volvo and Henlys.

The report tendered by Daniel Luthi, the former chairman of Working Party No 1 of the OECD Committee on Fiscal Affairs, explained that when "beneficial owner" was introduced into the MTC, the Working Party had a narrow view of its meaning. The intention was that agents or nominees should not be considered as the "beneficial owner" of income. However, there was no expectation that a holding company was a mere agent or nominee for its shareholders. In his view, a holding company would be the beneficial owner of dividends it received unless tax avoidance or treaty abuse was evident.

Prevost and the Minister of Revenue agreed that DHC was not an agent or nominee for Volvo and Henlys. However, the Minister of Revenue's view was that DHC was a conduit, funnelling dividends from Prevost to Volvo and Henlys. Luthi's report noted that a conduit could not normally be regarded as the beneficial owner of dividends if it has very narrow powers causing it to be a mere fiduciary or administrator acting on account of the interested parties. The Court agreed with Luthi, holding that the beneficial owner is the person who enjoys the attributes of ownership, possession, use, risk and control of dividends when they receive them. The dividend is for the owner's own benefit and they are not accountable to anyone for how they deal with the dividend income. However, the Court was of the view that DHC was in this position and was not a conduit.

ACJ Rip noted that DHC had no physical office or employees in the Netherlands, and had mandated TIM to transact some of its business. However, he held there was no predetermined or automatic flow of funds to Volvo and Henlys. Before these entities could receive dividends, DHC had to declare an interim dividend and then shareholders had to approve it.

### **Comment**

Following the judgment in *Indofoods*, Her Majesty's Revenue and Customs stated that they would apply an "international fiscal meaning" when interpreting the term "beneficial ownership" and deny treaty benefits if the use of the treaty was contrary to the objective of preventing fiscal evasion. For example, relief will be denied where a company is interposed in a favourable treaty jurisdiction merely to

circumvent withholding obligations. However, treaty benefits would not be denied in circumstances where there would be no withholding regardless of whether or not a company had been interposed. It is difficult to say whether the New Zealand Revenue will adopt the UK approach and treat the *Indofoods* decision as a reason to look through issuers or other special purpose vehicles when assessing withholding liabilities.

Some practitioners, in seeking to minimise the effect of *Indofoods*, have raised the argument that the Court of Appeal's decision is not authority for how to construe the meaning of "beneficial ownership" for the purposes of a DTA. This is on the basis that the Court of Appeal's view on this matter was a finding it made on a point of fact and not a point of law. However, it can be countered that the Court of Appeal was simply following the substantive, purposive approach to the concept of "beneficial ownership" taken by the OECD in their MTC and commentaries. There is no reason why New Zealand courts would not find the OECD interpretation of "beneficial ownership" similarly persuasive if the IRD, which generally follows the OECD line, advocated for this approach in an appropriate case.

The *Prevost* decision is currently on appeal to the Canadian Federal Court of Appeal. Advisors should give careful consideration to SPV structures seeking to benefit from a DTA until the position is more definitively resolved by case law or otherwise.